

Testimony before the Subcommittee on Aviation
U.S. House of Representatives
Committee on Transportation and Infrastructure

“The Financial Outlook for the U.S. Airline Industry”

September 28, 2005

Philip Baggaley
Managing Director
Standard & Poor's Ratings Services
A Division of the McGraw-Hill Companies, Inc.

Good afternoon, Mr. Chairman, members of the Subcommittee, ladies and gentlemen; thank you for the opportunity to testify today.

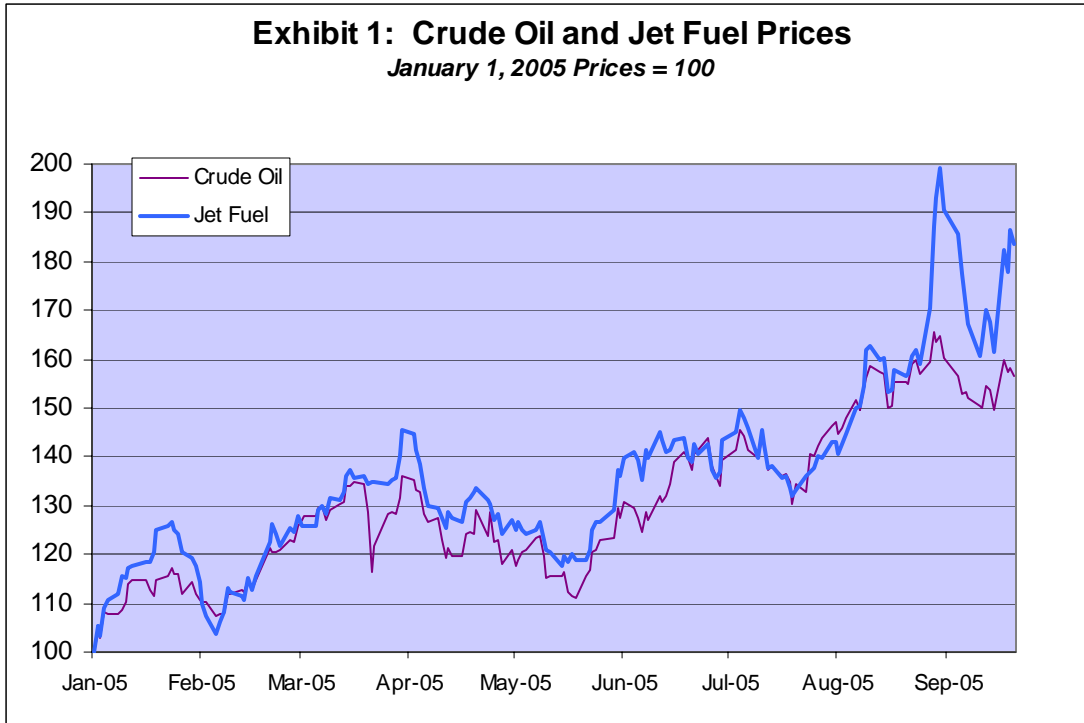
I am a Managing Director in the Corporates and Governments group of Standard & Poor's Ratings Services. I have been the primary credit analyst for the airline industry for the past 20 years. Standard and Poor's rates all major airlines in the U.S. and many major airlines throughout the world. Our ratings are current opinions about the creditworthiness of an entity, i.e. they speak to an entity's future ability to pay its financial obligations as they become due. As such, they should not be viewed as expressing an opinion on public policy matters. My comments should not be interpreted as being recommendations of any kind; they are Standard & Poor's Ratings Services' independent and objective opinion of the credit status of the airline industry.

The U.S. airline industry continues to struggle through a prolonged crisis, with three large airlines in bankruptcy and another emerging after two trips into Chapter 11. This grim situation is despite generally robust economic conditions and billions of dollars of federal cash grants and loan guarantees over the past several years. This afternoon, I hope to provide some perspective on the airline industry's problems by addressing three related topics:

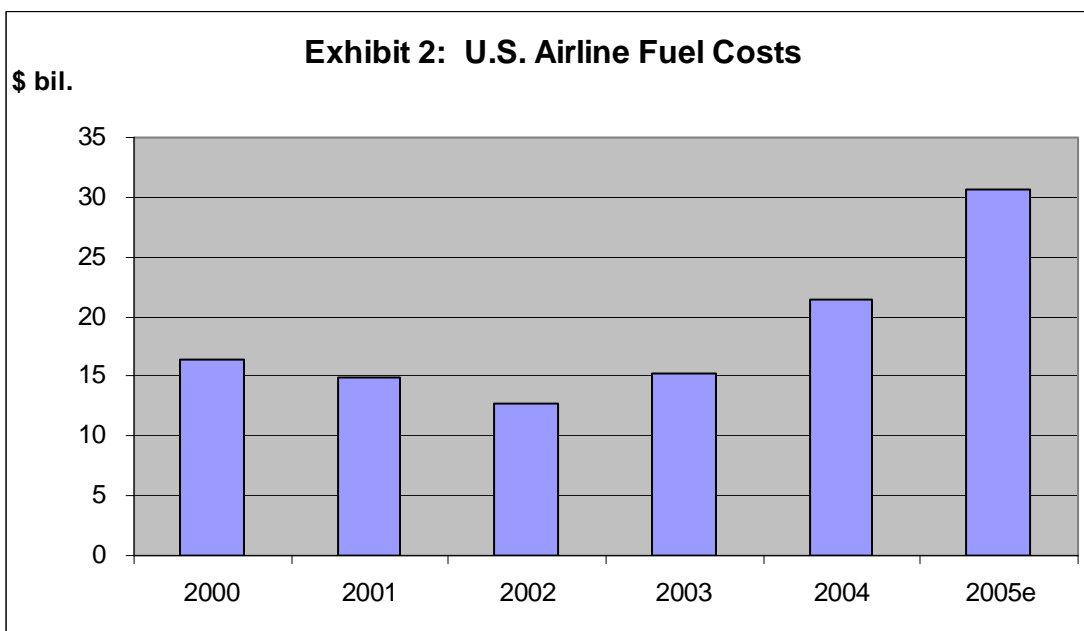
1. What are the principal causes of the U.S. airlines' current financial problems?
2. How are airlines responding to this situation?
3. What broader changes might improve the industry's prospects?

First, why are most airlines reporting losses and bleeding cash in a strong economic environment? Numerous factors have contributed to the problem--some inherent industry characteristics, some that date from the 1990s, and others that were serious concerns following the September 11, 2001 attacks. However, three factors stand out in the current environment: very high jet fuel prices, intense price competition in the domestic market, and heavy debt and pension burdens.

Fuel prices are the most serious concern at the moment. Oil prices have moved up in several large steps starting in the autumn of 2004, and the future outlook is for an extended period of high prices. Added to the high price of oil are the effects of limited refining capacity, which have widened the normal price difference between oil and jet fuel. Exhibit 1 shows the movement of oil prices and jet fuel this year, with the levels of January 1 set to equal 100.

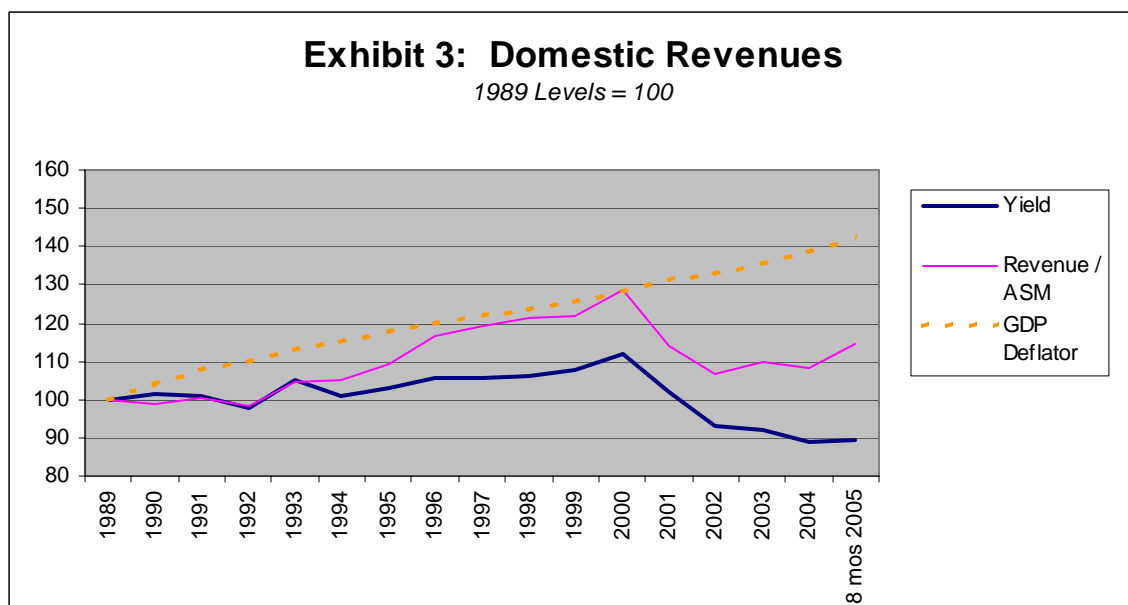


One can see the darker line representing jet fuel prices jump up above the lighter crude oil line over the past month, due to damage to refineries in the wake of hurricane Katrina. The Air Transport Association recently estimated that U.S. airlines will spend \$30.6 billion on fuel in 2005, compared to \$21.4 billion in 2004 and double 2003's \$15.2 billion, as shown in Exhibit 2.



This represents a huge added expense that has offset much of the painful cost cutting that airlines have undertaken in recent years. Even low-cost airlines are under pressure. Southwest Airlines would be operating at breakeven without its fuel hedges, and JetBlue recently warned that it could report losses. Standard & Poor's on September 21 placed its ratings on JetBlue on CreditWatch for a possible downgrade. Most airlines do not have the credit profile that would allow them to enter into hedges without putting up cash collateral, and thereby depleting their cash reserves. In any case, hedges cannot undo the current price levels, only protect against further increases. Airlines are seeking to raise fares to help cover the cost of higher fuel—an effort that has been partly successful in 2005, after years of price cutting—but the enhanced pricing only partly offset the higher fuel prices. Unlike railroads, trucking companies, and shipping lines, airlines do not provide their services under corporate contracts that often allow for fuel surcharges. Rather, they must attempt to raise fares in competitive markets, a move that requires all major players to follow suit or the attempted fare increase will fail.

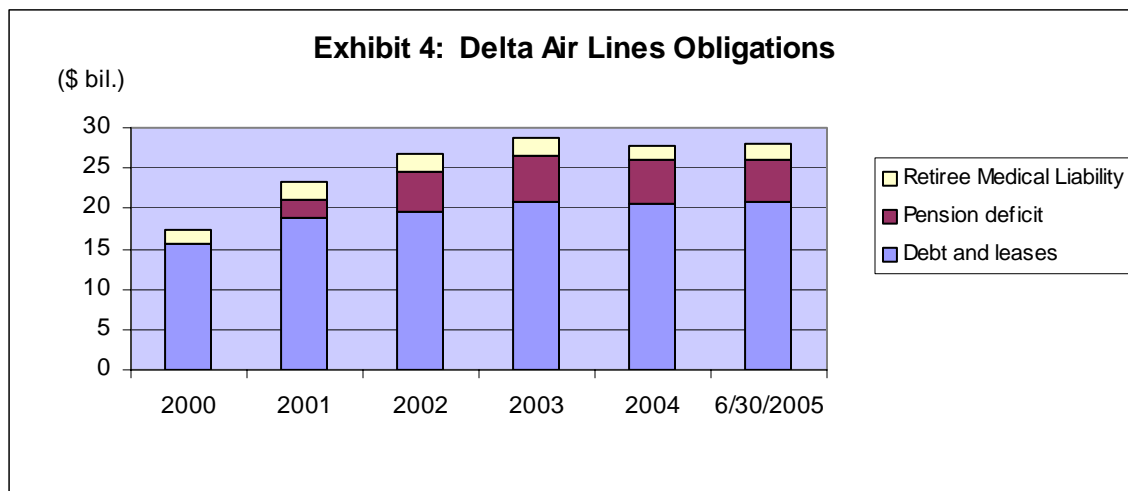
The second major cause of the airlines' financial problems is intense price competition, particularly in the domestic market. Exhibit 3 shows yield, the standard industry measure of pricing, and revenue per available seat mile, the measure of revenue generated per unit of capacity, as reported by the Air Transport Association, for this market.



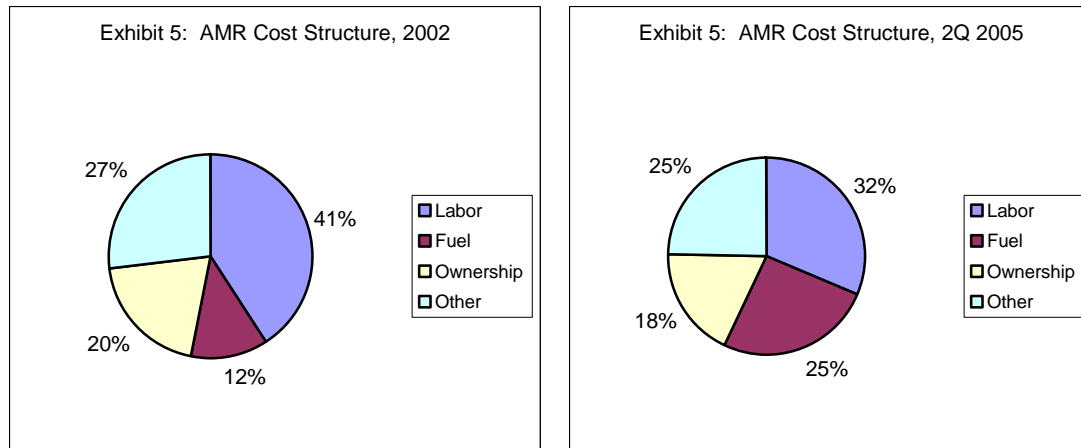
The data is expressed as an index, where the levels of 1989 are set equal to 100. Both measures turned sharply downward starting in 2001, and yield has not improved materially despite several years of economic recovery. Although the recession and September 11, 2001 attacks triggered the initial decline, they have since been superseded by other trends. The rapid spread of low-cost airlines and excess seat capacity have prolonged the pricing weakness, and at least the first of these appears to be a permanent change. Shown also in this Exhibit is an index of inflation, measured by the gross domestic product (GDP) deflator, with 1989 set to equal 100. The gap between this line and the two airline measures shows how much worse the decline of the past few years is

when measured in real, rather than nominal, terms. Over the past year, the pressure of high fuel costs has led to a series of fare increases, reversing the trend of the past several years. While this has been a welcome development, it may not last. If high oil prices cause the U.S. economy to slow, the recent momentum toward higher fares could stall.

The third big financial problem for airlines is a heavy burden of debt and pension deficits. Airlines tend to operate at higher leverage than manufacturing companies, even in the best of times. Starting in 2001, the “legacy carriers” had to borrow heavily to fund losses and maintain an adequate cash reserve, even with cash assistance from the federal government. On top of that, traditional defined benefit plans that were fully funded in the stock market boom of the late 1990s rapidly fell into deficits when share prices and interest rates fell. Exhibit 4 shows the effect for Delta Air Lines, with debt and the pension deficit mounting. The chart includes also liabilities for retiree medical obligations to show total debt and debt-like claims. All this was occurring at a time when Delta’s ability to service those obligations was drastically reduced, due to heavy losses.



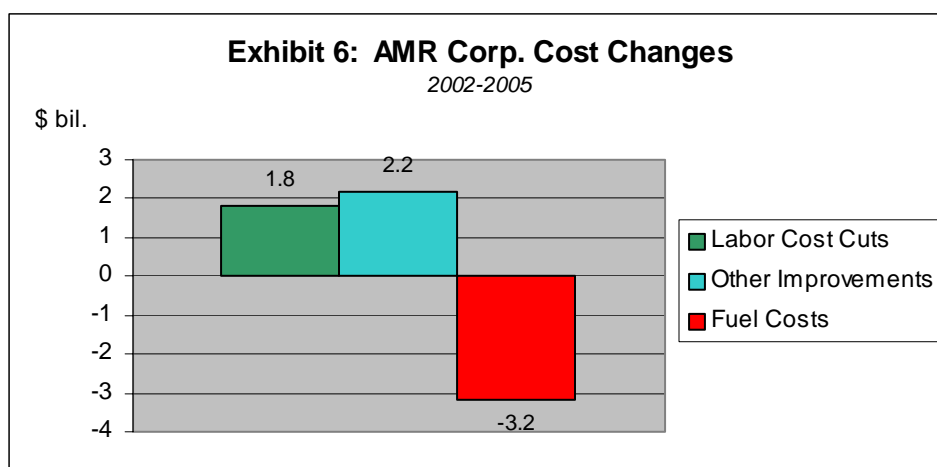
What have airlines been doing in response to these problems? The legacy carriers have been doing quite a lot, although you cannot fully see that from their financial results. First, airline employees have been asked to take substantial pay cuts, trim their benefits, and, in some cases, lose their jobs. Why has there been so much focus on labor costs? Exhibit 5, the two pie charts below, provides some insight.



It shows broad expense categories for AMR Corp., parent of American Airlines, in 2002 and in the most recent quarter of 2005. In 2002, labor represented 41% of total expenses—the largest category by far. Furthermore, two other categories—fuel and ownership costs (interest, rentals, and depreciation)—are either largely outside the airline’s control or inflexible in the short run. The category labeled “other” includes a variety of expense items, some of them, such as distribution costs and purchased services, areas where the airlines have made cost-cutting progress. In short, labor was a target for cost reductions because it was the largest expense and one that is within the control of management and unions. Following large concessions in the spring of 2003 and fuel price increases in late 2004 and early 2005, labor’s share of total expenses had declined significantly, to 32%, while fuel had more than doubled to 25%.

A second reason why legacy airline’s have sought labor cost reductions is that the pay scales, benefits, and work rules of the legacy carriers were simply much more costly than those of the low-cost carriers. In 2002, labor costs consumed 49% of AMR’s total revenues; for Southwest Airlines the equivalent proportion was only 36%. In other words, labor was a major area of competitive disadvantage, though not the only one. These labor cost differentials have narrowed, though not disappeared, with changes of the past several years.

All this is not to say that labor costs have been the exclusive focus of cost cutting and profit improvement. American Airlines asked its employees for \$1.8 billion of concessions in the spring of 2003, but they also pursued wide-ranging efforts to gain another \$2.2 billion from other sources. These include fleet simplification, changing hub operations, purchasing efficiencies, and other cost initiatives. Those efforts are harder to measure and are spread across more categories, but they do add up to real dollars. Exhibit 6 shows the relative scale of these various improvements and offsetting fuel cost increases for AMR between 2002 and 2005. The first two columns show financial gains from labor cost reductions and other publicly disclosed cost initiatives, while the third, negative, column is the largely offsetting increase of \$3.2 billion of higher fuel costs forecast over that period. The chart shows just how much cost improvement has been cancelled out by the higher fuel prices.



Legacy airlines like American are borrowing some lessons from low-cost carriers, but there are limits as to how far they can or should go in this direction. The story is more complex than the contrast sometimes drawn between costly, hub-and-spoke route networks and low-cost, point-to-point service. First, low-cost airlines have differentiated over the years and are no longer all Southwest Airlines clones. AirTran, Frontier, and America West operate low-cost, hub-and-spoke route networks. JetBlue and AirTran offer cabin service as good or better than that of legacy carriers in the domestic market. Nor are all the low-cost airlines doing well. ATA is in bankruptcy and Independence Air is at the verge of it. Historically, a large majority of low-cost new entrants have failed. Conversely, if we look outside the United States, there are plenty of financially successful airlines that operate hub-and-spoke route networks: Singapore Airlines and Cathay Pacific, for example. The hub-and-spoke system inherently carries higher infrastructure costs, but it also can generate higher revenues, particularly when it is part of an international route network and has connections to regional airlines. The goal is to find a balance of direct and connecting flights that meets current market realities, and to operate the overall system at the lowest possible cost.

The final question that I posed at the outset of my remarks is perhaps the most important one: are there broader trends or changes that could provide the answer to the industry's financial problems? I will consider three such possibilities: bankruptcies, mergers, and reductions in seat capacity. Bankruptcy may have the stigma of financial failure, but it also gives an airline tools to correct that situation. Exhibit 7 shows selected financial data for UAL Corp., parent of United Air Lines, in 2002, when they entered bankruptcy, and from the forecast included in the companies' bankruptcy disclosure statement.

Exhibit 7:

UAL Corp. : Before and After

(\$ bil.)	2002	Forecast post-bankruptcy	% change
Debt & Leases	24.1	18.4	-24%
Pension Deficit	6.4	0	-100%
Annual Labor Expense	7.0	3.9	-44%

Chapter 11 bankruptcy reorganization is intended to provide debt relief, so one might expect that this would be the principal change in the UAL's financial profile. As the exhibit shows, total debt and leases indeed decline between the end of 2002 and the forecast emergence from bankruptcy, but the percentage change is less than one might expect (-24%). Most airline debt takes the form of secured loans and leases, rather than unsecured debt. Whereas unsecured debt can be cancelled, and the creditors given shares in the new company, settlement of secured debt and leases is subject to negotiations with creditors. With aircraft values in a global market stronger now than when United filed for bankruptcy almost three years ago, the airline's bargaining leverage is less. Delta and Northwest will face this same issue—unsecured debt can be wiped out, but the scope for cutting secured debt and leases is more limited, except in those cases where the airline is willing to turn back aircraft to creditors.

The second financial item shown in Exhibit 7, pension shortfalls, is a different story. By persuading the bankruptcy court to terminate its pension plans, United wipes out an obligation on the same scale as its total debt reduction. Delta and Northwest have substantially underfunded pension plans, as well, and it appears likely that they may eventually seek to terminate some or all of those plans to facilitate reorganizing. From a purely credit perspective, eliminating all pension debt helps the bankrupt airline.

The third financial item in Exhibit 7 is annual labor expense. According to the company's forecast, 2006 labor costs are expected to be a substantial 44% lower than in 2002. This represents a combination of layoffs, pay cuts, and benefit reductions. It also includes some transfer of work from inside United to regional partners and maintenance contractors. United still has to pay for that work, but it is classified as a different type of expense (if one nets out the increase in outsourced work, labor costs in 2006 are forecast to be about 25% lower than in 2002). The United that emerges from bankruptcy will be a somewhat smaller airline, with fewer and lower-paid employees, than when it entered Chapter 11. Bankruptcy makes it easier for airlines to secure labor cost reductions, because, ultimately, the court can impose them. Delta and Northwest will seek to negotiate consensual concessions from their unionized employees, but now management's bargaining leverage vis-à-vis the unions is much stronger than outside of Chapter 11. In summary, bankruptcy can help an airline improve its financial prospects through debt reduction, pension terminations, and cost reductions. However, the struggles and continued losses of United, and the fact that US Airways paid a second visit to the bankruptcy court show that this is no panacea.

Mergers are a second broad change often suggested as a cure for airline industry problems. Rationalization of excess capacity and reduction in the number of competitors is seen as one way to correct an imbalance of supply and demand, and improve pricing. Yet, the track record of these combinations is poor, with few examples delivering on promised benefits. Airline mergers have historically been driven by a different rationale than those in most other industries. Combinations of manufacturing companies usually provide opportunities for cost cutting and eliminating duplicate facilities, but offer more limited and uncertain revenue gains. In contrast, airline combinations can generate added

revenue, but have historically often resulted in a net increase in operating expenses. Airline mergers generate added revenues through two principal means: diversion of traffic from competitors by creating a larger, more comprehensive route network, and increased pricing power through market control. Diversion of traffic is, by its nature, a zero sum game—what the merged airlines gain, others lose. Market control may result in less competition and higher prices.

While airline mergers can generate revenue benefits, the cost implications have historically been less favorable. The combination of two airlines offers some opportunity for savings through reduced overhead and increased purchasing power. However, that has usually been more than offset by higher labor costs as management “buys” the cooperation of organized labor needed for a smooth integration. United’s proposed acquisition of US Airways in 2000 led United to negotiate an expensive pilot contract that later helped push the airline into bankruptcy.

There is some reason to believe that airline mergers in the current industry environment will fare better, particularly if the acquired company is already in bankruptcy. America West’s pending acquisition of US Airways demonstrates one potential model. America West is pursuing the merger in part because:

1. US Airways has already secured extensive concessions and lowered its labor costs to levels approaching those of America West;
2. As a bankrupt company, US Airways has the flexibility to rid itself of aircraft and facilities that will not be needed in the combined airline; and
3. America West has managed to attract significant outside equity investment and new loans to bolster its cash liquidity.

The merged company will still face a difficult task in integrating its two labor forces over the next several years, and outside forces such as high fuel costs could still cause a renewed financial crisis. Even so, acquiring a bankrupt, but potentially viable, airline appears to avoid some of the pitfalls that have plagued previous mergers. The recent bankruptcy filings of Delta and Northwest have renewed speculation that they may eventually combine, and it does seem likely that some consolidation among the remaining five legacy carriers will occur over the next several years.

From the perspective of the airline industry’s overall financial health, the main potential benefit of airline bankruptcies and mergers is a reduction in overall seat capacity. That should, it is often suggested, improve the balance of supply and demand and allow for increased fares to cover added fuel expense and rebuild balance sheets. One of the most frequent criticisms of the bankruptcy process is that it has (along with federal aid in some cases) permitted struggling airlines to survive, to the detriment of their solvent competitors. There is no doubt that liquidation of a major airline in bankruptcy would allow surviving airlines to raise prices. However, whether that revenue gain is sustainable depends on where the parked aircraft end up, and whether the surviving legacy airlines have lowered their costs enough to remain competitive. If the liquidated airline’s planes simply change hands, or if low-cost airlines still have a huge cost

advantage, then the revenue benefits of an airline liquidation will likely erode over time. In other words, consolidation, whether through bankruptcy liquidations or mergers, will help the industry only if it is accompanied by withdrawal of planes from the U.S. market and by competitive cost structures at the survivors.

To conclude, let me summarize my answers to the questions posed at the beginning of my testimony. First, the dire financial condition of most U.S. airlines is due to high fuel costs, intense price competition in the domestic market, and heavy debt and pension burdens. Second, legacy airlines have undertaken significant steps to trim their losses, but these have so far been insufficient to restore profitability. Lastly, bankruptcy restructuring and mergers have the potential to improve the industry's financial health, but only if accompanied by reduced capacity and, most important, by lower operating costs.

Thank you for your attention.

Appendix

Standard & Poor's U.S. Airline Debt Ratings

As of September 28, 2005

Airlines are arranged from strongest to weakest, by rating category and outlook, except for bankrupt airlines, which are arranged alphabetically. The ratings are shown as follows: Long-term corporate credit rating/Outlook/Short-term corporate credit rating.

Investment Grade:

Southwest Airlines Co. A/Stable/--

Speculative Grade:

Alaska Air Group Inc. BB-/Negative/--
JetBlue Airways Corp. BB-/CreditWatch Negative/B-2
Continental Airlines Inc. B/Negative/B-3
AMR Corp. B-/Stable/B-3
AirTran Holdings Inc. B-/Stable/--
America West Holdings Inc. B-/CreditWatch Negative/--
FLYi Inc. CC/CreditWatch Negative/--

In Default:

Delta Air Lines Inc. D/--/--
Northwest Airlines Corp. D/--/D
UAL Corp. D/--/--
US Airways Group Inc. D/--/--